PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

WATER DIVISION **RESOLUTION NO. W-4294**
September 20, 2001

R E S O L U T I O N

(RES. W-4294), ALL WATER AND SEWER SERVICE UTILITIES. ORDER MODIFYING BALANCING ACCOUNT PROTECTION FOR OFF-SETTABLE EXPENSES.

SUMMARY

By various advice letters, water and sewer system utilities have in the past and will in the future be requesting revision of their tariff schedules to provide an increase in revenues to compensate for increased costs of purchased power since their present rates became effective. These offset rate increases should be allowed if the utility is not over-earning on a weather-normalized means test basis for Class A water utilities and on an actual basis for all other water and sewer system utilities. For Class A utilities the increases should be deferred to those utilities' next general rate proceedings if the subject district or company is under-earning but has not availed itself of its chance to file a general rate case under the Rate Case Plan (RCP).

BACKGROUND

In 1978, as a result of the oil boycott and major variations in cost for fuel oil and natural gas, the Commission authorized certain utilities to book the increased costs to balancing accounts for later recovery. About that same time, staff and the water utilities agreed that certain water utility expenses could be tracked by balancing accounts also. A balancing account for water utilities tracks incremental changes in costs and any corresponding Commission authorized incremental revenue adjustments for certain predetermined expense items. Any under-collections or over-collections shown in the account are disposed of by Commission order upon review by the staff as to the accuracies of the amounts booked. So for a balancing account the only issue is the amount. A memorandum account, on the other hand, is initiated by a specific event that might require rate relief and is established by Commission order. The memorandum account tracks expenses related to that event. The recovery of the expenses booked is subject to reasonableness review for both the type of expense and the amount and requires Commission order.

Expense Offsets for Water

Expense offsets were authorized by statute in 1976. Expense offsets were originally for electric utilities to track and recover fuel costs. The Commission established rules for applying them to water utilities on June 28, 1977, and rules for calculating them on September 6, 1978. The 1977 policy included a means test (Conclusions and Recommendations, p. 1, recommendation (c)):

> "Traditional test for offset proceeding be continued. These require, that with the offset, the rate of return not exceed that last authorized by the Commission and the amount of the offset not exceed the revenue increase.(sic.)"

but the 1978 policy did not. The 1978 policy stated the following:

a. The maintenance of balancing accounts for any given item will start from the date the Commission first authorizes new rates passing through specific changes in cost… all subsequent changes in cost of that item would be recorded in the balancing account as they occur.
b. Utilities should maintain three types of balancing accounts. A balancing account for all types of water production cost offsets including purchased water and purchased power, a balancing account for ad valorem tax offsets and a balancing account for all other types of offsets.

The 1978 policy went out to all Class A and B utilities.

Balancing Accounts for Water

In 1983 California water utilities met with staff and developed specific procedures for maintaining balancing accounts and applying for expense offsets. The instructions sent to the utilities by Executive Director Bodovitz on May 31, 1983 included the statement:

> "Balancing accounts maintained beyond the latest test year will use the latest adopted quantities. Those cases, where the adopted quantities do not exist or where the latest decision is older than 5 years, will be handled on a case by case basis, by the Commission staff." (Attachment to the letter, page 1)

Among the expenses that were allowed balancing account treatment were purchased water, purchased power, pump tax, postage and property tax. This list was modified in I.90-11-033 (the Risk Phase II proceeding) when postage and property tax were deleted (D.94-06-033, June 22, 1994, Ordering Paragraph 2), leaving purchased power, purchased water and pump tax (groundwater

extraction charges) as the only off-settable operating expenses. This proceeding was the first formal proceeding to address balancing accounts for water. In fact, one of the questions in the original OII was:

> "Should the Commission establish a program of complete revenue requirement protection for the utility through interest-bearing balancing accounts for all revenue requirements? If so, how should the Commission determine the appropriate rate of return?"

I.90-11-033 did not authorize any additional balancing (or memorandum) accounts, but it did address the issue of booking costs to such accounts. It allowed utilities to apply to book additional water quality costs to the Water Quality Memorandum Account provided the costs were:

> "…unforeseen and therefore were not included in the utility's last general rate case, that the costs will be incurred prior to the utility's next scheduled rate case (or otherwise cannot be estimated accurately for inclusion in a current rate case), and that the expenses are beyond the control of the utility." (D.94-06-033, p. 65)

Weather-Normalized Means (Pro Forma) Test for Water

On October 31, 1985 the Chief of the Water Utilities Branch, Wesley Franklin, sent a letter to all Class A, B and C water utilities promulgating "Guidelines for Normal Rate Making Adjustments in Connection with the Calculation of a Weather Normalized Pro-Forma Rate of Return on Recorded Operation for Water Utilities" (10/30/85). The first sentence on the cover letter read:

> "Since 1982, Commission staff and water utility industry have met on several occasions to discuss the appropriate method for determining the "Pro-Forma" Rate of Return to be used in step rate filings, *offset filings,* and for other earnings reports to the Commission." (emphasis added).

The Risk Phase II proceeding also addressed the Weather Normalized Means (pro-forma) test. It noted that one purpose of the test was to test second test year and attrition year rate increases against actual earnings:

> "If a utility is authorized to increase rates during the second test year or the attrition third year, the pro-forma test postpones or reduces an authorized increase if in fact the utility already is earning more than its authorized return. A DRA witness explained that if a utility is earning more than its rate case authorization, the pro-forma test does not require a refund. It simply prevents a full step-rate increase when the pro-forma earnings test shows that the utility already is earning more than its authorized rate of return at

> the time the step-rate increase is to become effective." (D.94-06-033, p. 60)

The Decision also noted that the Means test was probably too complicated for Class B, C and D utilities to calculate and that actual return should be used as the Means test for those utilities.

The following language is standard dicta for the ordering paragraphs of water decisions on how to apply the Means test:

> "On or after November 6, 2000, CWS is authorized to file an advice letter, with appropriate work papers, requesting the step rate increase for the year 2001 included in Appendix B or to file a proportionately lesser increase for those rates in Appendix B for the Bear Gulch, East Los Angeles, and Visalia districts in the event that a district's rate of return on rate base, adjusted to reflect rates then in effect and normal ratemaking adjustments for the 12 months ended September 30, 2000, exceeds the lower of (a) the rate of return found reasonable by the Commission for CWS during the corresponding period in the then most recent rate decision or (b) 8.79%. This filing shall comply with GO 96-A. The requested step rates shall be reviewed by Water Division to determine their conformity with this order and shall go into effect upon Water Division's determination of conformity. Water Division shall inform the Commission if it finds that the proposed step rates are not in accord with this Decision or other Commission decisions. The effective date of the revised schedules shall be no earlier than January 1, 2001, or 30 days after filing, whichever is later. The revised schedules shall apply only to service rendered on or after their effective dates." (D.99-05-018, Ordering Paragraph 4)

Over the years many water and sewer service utilities have filed for offsets for changes in expenses. Staff has reviewed the filings and generally created resolutions to approve those requests. Whenever such requests are granted, the resulting incremental revenues, and the incremental expense increases, must be booked to a balancing account in accordance with Public Utilities Code Section 792.5.

Effective January 4, 2001 and March 27, 2001, PG&E increased rates for purchased power by one cent per kilowatt-hour (kWh) and three cents per kWh, respectively, pursuant to D.01-01-018 and D.01-03-082.

Southern California Edison increased its electric rates effective June 1, 2001, per D. 01-05-027.

As a result of these increases, approximately a dozen water companies have filed for offsets. Staff expects that the rest of the approximately 150 water and sewer systems the Commission regulates will also be requesting rate increases.

NOTICE AND PROTESTS

Mrs. Pearl S. West addressed the Commission at its meeting of June 26, 2001 and questioned the process used to allow offsets to rates for California Water Service Company's Stockton District.

The Office of Ratepayer Advocates (ORA) filed a late-filed protest to California Water Service Company's (CWS) Advice Letter 1493 on July 6, 2001. In that document, ORA recommended that the Commission reject the advice letter on the grounds of over-earning. It pointed out the Stockton District of CWS is earning an overall rate of return of 10.21% when their last authorized rate of return was 8.79%. It also noted that the Stockton District's last rate case concluded in 1995. CWS could have filed for a rate increase for Stockton effective in 1998, but chose not to do so. In ORA's opinion the reason CWS has not filed for Stockton is that it has been over-earning since that time.

CWS responded to ORA's protest by letter dated July 20, 2001. In its response CWS noted that the data ORA relied upon to show over-earning was not weather adjusted. Because rates are set based on long-term average factors to determine water sales, in some years revenues will exceed estimates and in others revenues will be less than estimates. CWS noted that the data included some of CWS's largest sales months in history and that since the date (September, 2000) water sales have significantly declined. The response pointed to the weather normalized means (pro-forma) test as the proper test to use, but noted that the test has never "…been used to reduce or eliminate the recoverability of Cal Water's purchased power or purchased water costs."

CWS further objected to ORA's request that CWS be prevented from "booking into the balancing account any increase in costs in district 'for which it could have but has elected not to file a general rate increase request'" as a change in policy that should be addressed in a generic proceeding. CWS pointed out that not filing for a GRC might be due to other factors than over-earning. CWS notes that "general rate increases are time consuming, costly and contentious" and that "Cal Water may choose not to file… because of community relations or other intangible factors not directly related to rate of return." When it doesn't file for a rate case, CWS maintains that the utility has an incentive to operate more efficiently.

CWS claims that the impact of removing balancing account protection for purchased power would result in nine additional CWS rate increases filed this year, a potential loss to the company of between seven and nine million dollars and a possible downgrade in CWS's credit rating. Attached to the response, at

staff's request, CWS included weather-normalized means test calculations for all of its districts for the 12-month period ending June 1, 2001.

ORA commented on CWS's response of July 24, 2001. In its comment it noted that CWS had provided no back up for its statements about its higher than normal sales, lack of rainfall and higher than normal temperatures. It also noted that although no restrictions exist to limit the use of balancing accounts, there is also no requirement to allow the cost pass-throughs that trigger them.

DISCUSSION

The Water Division (staff) has evaluated the protest, response and comment and reviewed the history of offsets and balancing accounts (a précis of which is provided above in Background). After consideration, staff recommends that the Commission do the following:

1) discontinue the ability of Class A water utilities to automatically book increased expenses into balancing accounts for later recovery.

2) approve all offset requests by a Class A utility for the utility or district if it is not over-earning, using the weather-normalized means test, and if the utility or district is within the three-year rate case cycle, subject to refund,

3) suspend advice letter requests for offsets if the Class A utility is over earning on a weather-normalized means test basis or the Class B, C or D utility is over earning on an actual basis, whether the utility or district is within the rate case cycle or not, and not allow that expense to be booked to the balancing account,

4) order utilities or districts who have chosen to forgo filing a GRC, but are not over-earning on a weather normalized means test basis, to book the incremental purchased power expense, and any subsequently incurred off settable expense, to a memorandum account to be recovered in its next GRC, which must be filed within the time period allowed in the Rate Case Plan[1], and,

5) open an Order Instituting Rulemaking to determine if these changes to the off-settable expenses and balancing account guidelines are appropriate, should be modified and should be made permanent.

These positions are explained more fully below:

Discontinue the ability of Class A Water Utilities to Accrue Increased Expenses in Balancing Accounts for Later Recovery

[1] D.90-08-045, August 8, 1990 established a three-year filing cycle for Class A General Rate Cases. It authorized two test years and an attrition year for January filers and a second, partial, attrition year for July filers.

This change would eliminate the Class A utilities' ability to use balancing accounts to book changes in off-settable expenses, except for the incremental expenses and incremental revenue associate with an approved rate offset. This would return balancing accounts to the purpose defined in P. U. Code Section 792.5, that of assuring dollar-for-dollar recovery of passed-through rates. Utilities would still be allowed to request offset rate relief for purchased water, purchased power and pump taxes, but relief would be limited by the tests described below.

Approve an Offset Filing if the Utility or District is not Over-earning and is Within the Rate Case Cycle.

Clearly, ORA is not protesting the approval of an offset rate increase if the utility is not over-earning on a Weather-Normalized Means test basis and if the utility or district has been subject to a general rate proceeding within the three-year rate case cycle. In accordance with past Commission policy, requests that meet these requirements should be approved.

Reject the Request if the Class A Utility is Over-earning using the Weather Normalized Mean Test or the Class B, C or D Utility is Over-earning on an Actual Basis.

In its protest, ORA used the actual rate of return for CWS's Stockton District for the 12 months ending September 2000 and compared it to the adopted rate of return from CWS's 1995 rate case. The problem with this comparison, as CWS points out in its response, is that water sales (an increase in which is by far the most probable cost of over-earning) are estimated using a long-term average process[2]. So using actual earnings is not a fair standard.

In order to get around this problem and make the test fairer, staff and the utilities developed the weather-normalized means test that calculates the rate of return, but keeps the sales per (residential) customer constant at the last adopted sales and uses actual rate base. Using this test, the utility will over-earn only if customer growth is greater than anticipated, or rate base growth is less. This is the test that applies to step (second test year) and attrition year rate increase requests that are associated with a GRC. In the past staff has applied this test to offset requests but only to determine if recovery should occur immediately, or if it should be delayed until the utility was under earning. The reason that the recovery was delayed, rather than disallowed, was because the particular

[2] Using a linear regression program, the actual sales for a particular district are regressed against explanatory variables, such as temperature and rainfall. This results in a mathematical model of that district's usage. To estimate future sales a long-term (30-year) average of temperature and rainfall (for example) are inserted into the model, resulting in the estimate of average (long-term) future sales per customer. Thus, on average, actual sales per customer will be higher than estimated about one-half of the time. (This assumes that there is no underlying influence resulting in continually increasing water sales per customer, such as increased density of swimming polls with time in a district. If this is the case, the above process is inadequate.)

expense was eligible for balancing account tracking. Since the balancing account process was established prior to the weather normalized means test, and since the application of the means test to the balancing account was never clarified, in the past the utility could simply delay filing for the offset until it passed the means test. Any unrecovered costs were booked to the balancing account for later recovery by surcharge.

Now ORA has raised the issue of whether a water utility should be allowed to defer recovery. The Commission already uses the weather-normalized means test to test the earnings prior to authorizing rate increases for the second test year and the attrition year for general rate cases[3]. The test is applied as follows: for the second test year, if the utility is over earning, the increase in rates is either disallowed, or only partially allowed if the return is close to what was authorized. The utility must undergo the same test twelve months later to see if the attrition increase is allowed, and again twelve months later to see if the second attrition increase is allowed, if the utility is a July filer. ORA is proposing that something similar happen to utilities at the time an off-settable cost increases, whether the utilities chose to file for an offset at that time or not. To apply this test in a similar fashion as it is applied to step and attrition filings, if the utility were over-earning when the cost change occurred, the utility would not be allowed to book the cost change to its balancing account, or could only book part of the change if the test were close. Later, either at the time of the next off-settable increase or possibly after 12 month's, the utility could apply for revenue offset and again undergo the means test. If it passed, the offset would go into rates and the balancing account would again track the new increased revenues against increased costs. If the utility failed, the balancing account would not be allowed to track the new expense. Using this process, the Commission could apply this test to the offset increase and, because the utility is already earning the higher revenue, and will continue to earn the higher revenue in the future, deny or limit recovery.

The equivalent of this test is the actual earning test for a Class B, C or D. Since the probability of these systems over-earning due to customer growth or a slower growth in rate base is small, testing for over-earning using actual earnings is reasonable for these utilities.

<u>Order Class A Utilities Or Districts who have chosen to Forgo Filing a GRC, to book the Incremental Off-settable Expense to a Memorandum Account to be recovered in its next GRC, which must be Filed within One Year of the Effective Date of this Resolution.</u>

The issue of delay in filing for a rate proceeding was raised in the Risk Phase II proceeding and is raised again by ORA in its protest. In I.90-11-033, DRA staff

[3] Class A water utilities operate under a three year rate case cycle (see D.90-08-045, August 8, 1990, the "Rate Case Plan" (RCP)) consisting of two test years and an attrition year, and a second, partial, attrition year for July filers.

requested that water utilities be ordered to file mandatory rate cases every three years. The Commission rejected this request noting:

> "6. DRA has failed to show that mandatory rate cases every three years for all Class A water districts will accomplish more than regular review of water district financial filings." (D.94-06-033, Finding of Fact 6)

Although the Commission in 1994 decided that utilities shouldn't be required to file regularly for a GRC, the situation at that time was different than the situation today. In 1994 we were in the third year of a hiring freeze, and the state's economy was in a recession. The effect on state agencies was to curtail expenses wherever possible. But, as pointed out by DRA in the Risk Phase II proceeding, Section 314.5 of the Public Utilities Code requires the Commission to audit utilities serving over 1,000 customers every three years and those serving less than 1,000 customers every 5 years. Traditionally, for water, this audit is performed at the time of the GRC. While the elimination of balancing account protection imposed by this resolution will not mean that water and sewer service utilities will have to file GRCs every three years, it will make it more likely that utilities will file regularly, and allow the Commission to more closely fulfill the requirements of the Public Utilities Code.

Arguably, by bypassing its chance to file a GRC, the utility should no longer be protected from unanticipated expense changes, as the Commission did in limiting memorandum accounts to expenses that occur prior to the next GRC. Also, if utilities can automatically book increases for purchased water, power and pump tax costs, they will more likely delay filing. CWS in its response lists other reasons to avoid filing. Another likely reason for a utility to delay filing for a GRC is that in recent GRC proceedings, ORA has been successful in convincing the Commission to lower the adopted return on equity. If a utility or district has rates set a few years ago at a higher return on equity, the utility is more likely to skip or delay in filing a GRC for that district. But, as stated in the 1983 instructions, delays are problematic for off-settable expenses because the rate calculations are set on adopted quantities. As the adopted quantities get more out of date, the correctness of the rate levels gets shakier. And, finally, from a procedural point of view, by choosing not to file a GRC the utility has effectively given up any opportunity to consider any changing situations that might affect its costs, including off-settable costs. For all of these reasons, by choosing not to file a GRC, the utility should lose the opportunity to continue to have purchased power, purchased water and pump tax balancing accounts beyond its next GRC filing date per the Rate Case Plan. As there is not Rate Case Plan for Class B, C or D utilities, this order should not apply to them.

Staff recommends that the Commission address these inequities as follows:

1. If the utility has chosen not to file for a general rate increase within the three years allowed by the rate case plan, offset protection for new expense changes should be denied.

2. Because this change is reasonable, but has not been promulgated to the utilities, the Commission should establish memorandum accounts to track formerly off-settable expenses for utilities and districts that have chosen to not file by the three-year rate case cycle. These memorandum accounts should be recovered as part of a general rate case filed within the period of time allowed in the rate case plan for its next GRC filing. If not so requested, recovery of the memorandum account should be denied.

This will protect any utilities that have not filed for a GRC on the normal rate case cycle, by giving them one year to prepare and file.

In the Southern California Water Co. Headquarters case, this Commission clearly stated that memorandum account tracking could only occur prospectively:

> "It is a well established tenet of the Commission that ratemaking is done on a prospective basis. The Commission's practice is not to authorize increased utility rates to account for previously incurred expenses, unless, before the utility incurs those expenses, the Commission has authorized the utility to book those expenses into a memorandum account or balancing account for possible future recovery in rates. This practice is consistent with the rule against retroactive ratemaking." (Emphasis in original.) Decision 92-03-094 (March 31, 1992) 43 Cal. P.U.C. 2d 600

Therefore, we will only allow the tracking of expenses incurred after the establishment of this memorandum account.

Finally, the Commission should order staff to prepare an Order Instituting Rulemaking for Commission consideration to take input from the affected parties to see if these changes are just and reasonable.

COMMENT

This resolution was sent to all regulated water and sewer system utilities for comment. The comments included: _____

FINDINGS AND CONCLUSIONS

The Commission finds, after investigation by the Water Advisory Branch, that the procedures authorized herein are justified and the resulting rates are just and reasonable.

IT IS ORDERED that:

1. Water Division staff will review all offset advice letters for compliance with the provisions of this resolution. If found to be in compliance, and if the rate calculations are correct, staff is authorized to approve the rate increase requests, subject to refund.

2. Class A water utilities shall no longer track increased off-settable costs by booking them to a balancing account. Decreased off-settable costs shall continue to be booked to the account.

3. If the Class A utility or district is over-earning on a weather-normalized means test basis, or if the Class B, C or D utility or district is over-earning on an actual basis, the utility shall not get an offset increase.

4. If the Class A utility or district has not filed a general rate case in accordance with the rate case plan three-year cycle, the utility shall not get an offset increase.

5. All Class A Water Companies' districts, which have not filed a general rate case using the normal rate cycle in the rate case plan, may continue to track increased off-settable costs in a memorandum account for potential recovery in their next general rate case application. Such rate case application must be filed within the time allotted in the Rate Case Plan, or recovery of the memorandum account will be denied.

6. Water Division shall prepare for Commission consideration an Order Instituting Rulemaking that will address these changes.

7. Because accrual in a memorandum account cannot occur before the establishment of the account, this resolution is effective today.

I certify that the foregoing resolution was duly introduced passed, and adopted at a conference of the Public Utilities Commission of the State of California held on September 20, 2001; the following Commissioners voting favorably thereon:

WESLEY M. FRANKLIN
Executive Director